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I suggest to you that the questions to which we have to bend our intelligence are the causes of the collapse of investment and the means of reviving investment. We cannot hope either to prophesy or to limit the duration of the slump except as the result of our understanding of these phenomena.

—J.M. Keynes, *The Collected Writings, Volume XIII*,
“The Originating Causes of World-Unemployment,” 1931

LIES, DAMNED LIES, STATISTICS

Recent reports about the U.S. economy’s recovery have turned from optimistic to outright euphoric. Conventional projections for real GDP growth in the third quarter have been jacked up to the range of 5–7% at annual rate. Considering that this growth rate comes from 1.4% in the first quarter, this acceleration certainly looks highly impressive. The Commerce Department reported its first estimate for the quarter on Oct. 30, which happens to be the day this letter went to the printer.

In recent issues of this letter, we have rigorously disputed the bullish consensus view that the U.S. economy is on track for a strong recovery, let alone one of sustained, strong growth. In this letter, we continue this search for the truth.

The general, conventional argument is that, beginning with the second quarter, spending both by consumers and businesses has been surging. As to that quarter, we can only repeat what we have always emphasized: it is statistical spin. Virtually all of the reported acceleration in real economic growth has resulted from sharply lower price deflators, expressed in chained dollars.

But in the real world, all money paid and received is in current dollars. In these dollars, being the dollars that reflect actual sales growth and that also make the profits, economic activity has just edged forward.

As to the third quarter, we read in *BusinessWeek* that splendid third-quarter profits have “*investors dancing in the aisles*.” Considering the dismal profit performance of the past several years, we fully understand that any improvement, however modest, causes great cheers. But we do not see the rebound that is normal and necessary for a sustained economic recovery. Though earnings are up on average, the results vary tremendously between sectors and firms. From the same report, we learn that profits of industrials in the S&P 500 were down 16% against the same quarter last year, even though the dollar’s decline boosted most multi-national earnings.

Disputing the existence of a genuine U.S. economic recovery, we focus on inherent key ingredients and conditions: Job creation, income growth, investment spending, corporate balance sheets and profits. They continue to display familiar weakness. No recovery will seem real and lasting until employment and income figures strongly improve.

Measured by quantity of money and credit growth, the Greenspan Fed’s monetary policy is definitely by far the most successful in history. During the two-and-a-half years from the start of the recession-year 2001 to mid-2003, total outstanding credit skyrocketed by \$5.7 trillion, of which \$3.4 trillion was nonfinancial and \$2.3 financial.

But measuring the traction of this fantastic money and credit creation on the economy, Mr. Greenspan’s policy was the most ineffective in history, resulting during the same period in merely \$823 billion nominal

GDP growth. It took about seven dollars of new debt to generate one dollar of GDP growth. It was the highest debt-to-GDP ratio ever, and what's more, it keeps getting worse.

For comparison: During the two-and-a-half years from the start of the recession-year 1991 to mid-1993, total credit grew \$1.8 trillion, of which \$1.3 trillion was nonfinancial and \$0.5 trillion financial. In the wake of this modest credit expansion, nominal GDP grew \$793.5 billion. For each dollar added to GDP, there were only 2.2 dollars added to total indebtedness.

This certainly signifies a tremendous loss of traction for credit growth between these two periods that essentially raises the question of its causes. Policymakers and economists, in any case, discard the runaway debt growth as harmless because it has been accompanied by still bigger gains in market valuations of stocks and houses. Taking them into account, consumer net worth — that is, the value of assets minus debts — has effectively been rising.

Thinking this over, the first thing to appreciate is that this jolly perception of increasing asset prices as wealth creation is a complete novelty in economics. The old economists would have laughed at the idea. For centuries, wealth creation meant only one thing to economists as well as ordinary people around the world: creation of productive, income-creating capital assets such as buildings, plant and equipment through saving and new investment.

Even in the United States, as a matter of fact, the use of this new popular label for rising asset prices is of recent origin. It was definitely not yet customary in the 1980s. When Japan's real estate and stock prices exploded in the late 1980s, the Japanese policymakers frankly referred to it as an asset bubble and a bubble economy. Manifestly, the two expressions are not to the liking of American policymakers and economists. Their preference is to call it wealth creation.

By definition, an asset bubble signifies a rise in assets' market prices that has lost any reasonable relationship with their current yields; and a bubble economy, by definition, characterizes an economy where inordinately rising asset prices spur an excessive borrowing and spending binge either by enterprises for capital investment (as in Japan during the late 1980s) or for consumption by private households (as in the United States and England more recently).

The habit of private households to abolish saving from current income and to spend in excess of their current income for years is, actually, also unprecedented for America. Compared to past generations, there has been a radical, general change in mentality concerning money affairs. But for this change to happen, two other conditions were indispensable: first, the development of extremely aggressive lending institutions for consumer credit; and second, a very loose monetary policy, removing any restraint on credit expansion.

MACRO VERSUS MICRO

What is wealth creation? Frankly speaking, we have hesitated to pose this question. It seems too stupid. Considering, however, the widespread complacency in America about the presumed wealth creation through the housing and stock bubble allowing consumers to keep spending in excess of their current income, we feel that this question has to be posed and answered.

Economics has, as a matter of fact, two different branches. The one is macroeconomics, being the theory of the whole economy; and the other is microeconomics, being the theory of the individual firm or private household. The problem is that micro and macro logic can be flatly contradictory.

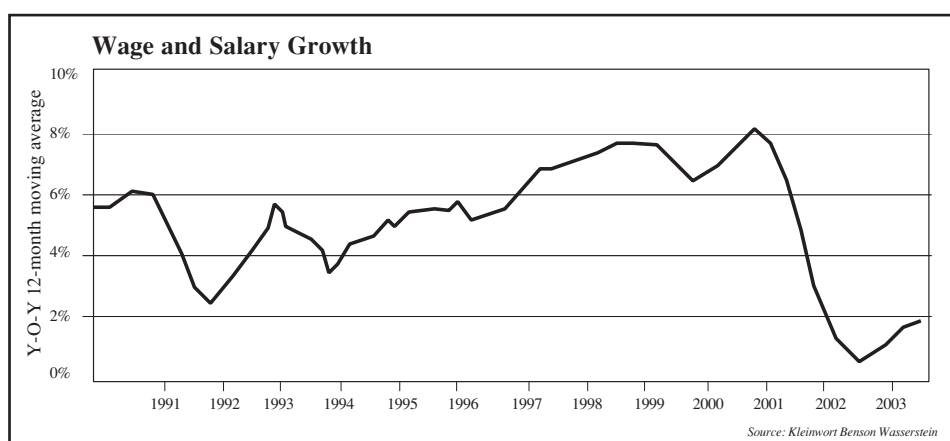
Actions that seem favorable for the profits of a single firm can be disastrous for firms and their profits in the aggregate, when most of them pursue the same kind of action. The old economists were well aware of this dichotomy between micro and macro perspective and called it the fallacy of composition.

Long ago we realized that our numerous disagreements with the economic consensus view in the United States originate precisely in this dichotomy. Focusing exclusively on the microeconomic perspective, American policymakers and most economists have apparently completely lost sight of the pernicious, longer-term macroeconomic consequences inherent to certain actions.

A particularly conspicuous case of this kind is the corporate mania to create and restore profits by cutting costs. Caught in the same kind of thinking, economists typically keep making highly optimistic profit forecasts with precisely this argument.

Looking at a single firm, it indeed seems the most logical device. But from the perspective of corporations as a whole, in other words, from the macro perspective, it is very bad corporate strategy. General cost cutting essentially leads to lower profits in the aggregate for the obvious reason that one firm's expenditures are implicitly other firms' revenue. When most firms cut their expenses, they only cut each other's revenues — and profits. Slashing their labor costs, firms slash the purchasing power of their customers. For us, therefore, all those optimistic profit forecasts, based on cost cutting, are grossly ill guided.

Wage and salary income rose only 0.1% in August, with a year-over-year gain of 1.8%. That's down from 8% before the recession. In the cost-cutters' view, this ought to have enormously boosted profits. It clearly has not done so. Such a virtual collapse of income growth from employment has no precedent in the whole postwar period. Together with the plunge in business investment spending, it would have pulled the U.S. economy into its deepest and longest recession.



What the U.S. economy experienced in 2001, instead, was an unusually shallow recession. But the sluggish growth and in particular the slide of jobs and incomes that has since followed compare miserably with past experience in 50 years, even though monetary and fiscal policy went on an unprecedented stimulatory rampage.

Not knowing the causes, Mr. Greenspan keeps fighting the symptoms. Realizing that the rock-bottom short-term interest rates lacked the necessary traction on the economy, Mr. Greenspan and company decided to operate on long-term rates through stimulating the "carry trade," in which speculators borrow short-term funds at around 1% and buy longer-term paper yielding 4–5%, and then heavily leverage up.

It worked amazingly well. Just by telling the public that a virulent deflation problem in the U.S. economy might require the Fed to buy long-term bonds, Mr. Greenspan triggered a ferocious stampede by the financial community into the carry trade of bonds that implemented a quick and steep drop in the yields of long-term bonds.

As mortgage rates slumped in concert with government bond yields, the bond bubble fuelled, in turn, the housing bubble that enabled and induced the consumer to go on a new borrowing rampage through mortgage refinancing. Measured by the growth in consumer spending, it was a successful policy.

Apparently most American economists also regard this as successful policy. Creating three new, but definitely unsustainable, bubbles is in our view the policy of a desperado for whom no tomorrow exists. As the bond bubble has burst, the bursting of the associated housing and mortgage-refinancing bubble can only

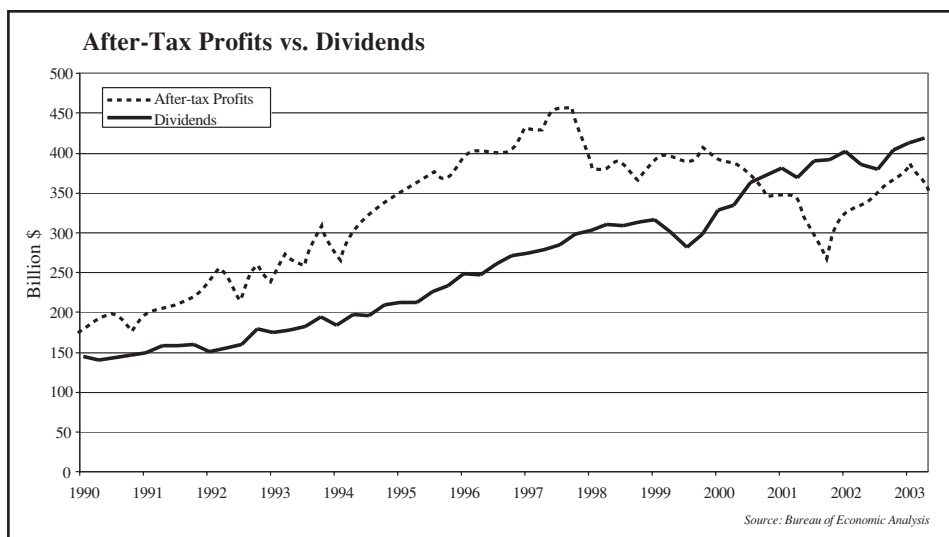
be a question of time. There can be no doubt about the immediate further consequence: sharply lower consumer spending.

Another typical case of fallacious microeconomic thinking is the general perception that rising asset prices create wealth and represent a valid substitute for saving. Again, for the individuals owning such assets, this seems reasonable. But looking at the economy and the public in the aggregate, it is an illusion.

Those who do not own a house suffer a corresponding loss of purchasing power in the housing market. First-time buyers are hit by the escalation in house prices when they decide to buy a house. Others will sooner or later be hit by rising rents. In other words, asset bubbles favor one group of people or businesses at the expense of others. The obvious main loser, actually, is the younger generation. From the macro perspective again, rising asset prices create pseudo-wealth.

In reality the key problem is the macroeconomic function of savings in the economy and the long-term consequences of their lacking. America is historically notorious for low savings and investment ratios. Net national saving fell dramatically in the 1980s, mainly due to soaring budget deficits. But the dramatically new situation today is that net national savings have plunged into negative territory.

It started in 1997 with the rapid run-down of personal saving, fueled by soaring stock prices. In the course of 2001 this rapid and massive personal dissaving was joined by rapidly rising government dissaving, as the federal budget turned into a soaring deficit. Both troubles are widely discussed. Yet there is a third component that has fared worst of all, although it is of crucial importance for business capital investment. That is business saving, better known as undistributed profits.



The plunge of this savings component started in 1998, as businesses kept raising their dividend payouts in the face of diving profits. Since 2001, the recession year, dividend payouts have been persistently in excess of corporate earnings with the result that business saving has become heavily negative, reflecting the fact that a substantial part of the dividend payouts is funded with borrowed money.

Most astounding and shocking is definitely the general American nonchalance towards the monstrous trade deficit. It is shocking because it reveals virtual ignorance of its disastrous macroeconomic implications to the domestic economy. Not so long ago, Mr. Paul O'Neill, at the time America's Treasury secretary, discarded it as a "*meaningless concept*," merely reflecting the fact that foreigners, attracted by superior returns, want to invest in America.

In essence, a current-account deficit diverts an equal amount of domestic spending away from domestic to foreign producers. It should be clear that such a deficit of now more than \$500 billion, or more than 5% of GDP per year, implicitly exerts a tremendous drag on the revenues and profits of producers in America. Just to compensate this loss to domestic spending and incomes requires equally massive domestic credit and debt creation.

JAPANESE PHANTOM GROWTH...

Lately, international investors have become enthusiastic about Japan's economy and stock market. Several American investment banks have trumpeted that the turnaround of Japan's economy has arrived. Foreign investors have been pouring money into Japanese stocks, boosting in the same vein the yen. Officially, Japan's real GDP grew in the second quarter by a sensational 3.9%, beating America's growth rate of 3.3%.

Our knowledge about Japan's economy comes exclusively from the monthly reports of its central bank, the Bank of Japan. Its September report stated:

Economic activity still continues to be virtually flat as a whole, although signs of improvement have been observed in such areas as the environment for exports. With regard to final demand, business fixed investment is recovering gradually. Meanwhile, private consumption continues to be weak, housing investment remains sluggish, and public investment is declining. Net exports are virtually flat. Industrial production continues to be basically level in response to these developments in final demand, and corporate profits are on a moderate uptrend.

This hardly reads like the description of an economic recovery. But how to reconcile this dismal description of the economic situation with the officially reported stellar real GDP growth rate of 3.9% for the second quarter? Putting it bluntly: It is exactly the same statistical hoax as the 3.3% simultaneously reported for the U.S. economy. Japan's statisticians have learned from their American colleagues how to conjure up the perception of an economic recovery that does not exist.

Yet in Japan's case, there were some critical comments in the press. A report in the *Financial Times* quoted an economist as saying that "*the government deliberately manipulated statistics*" using in particular an "*incorrect measure of deflation.*"

This, in turn, provoked a reply from the head of the Japan's Department of National Accounts, a Cabinet Office. In his letter to the *FT*, the director explained that the "*basic price statistics used in Japan's GDP deflators, such as the consumer price index and corporate goods price index, adopt the hedonic method to track price changes accompanying quality improvement in its goods*" — stressing that this is common international practice.

To be precise: Just like the practice of annualizing quarterly numbers, this is an American, not an international, practice. Without the annualization, reported real GDP growth would have been 1% in the quarter, and 3% year-over-year. In today's world of sluggish growth, that would also be impressive, if its main source was not hedonic pricing of computers. Under its impact, nonresidential investment grew 4.7%, or a stunning 20.2% at annual rate.

Measured in current prices, a radically different picture emerges: Japan's nominal GDP grew during the quarter by a dismal 0.3%, or 1.2% at annual rate. Year-over-year, it was up 0.5%. Repeating the first sentence of the above citation from the Bank of Japan: "*Economic activity still continues to be virtually flat as a whole.*"

Assessing the Japanese economy's performance and prospects, there is a broad choice. If you want to see an economy and a stock market powering ahead, focus on the 3.9%, as measured in real terms and annualized; if you want to see an economy that remains stuck in the post-bubble aftermath, focus on the 0.3%, as measured in nominal terms and without annualization.

Such a vast difference in measured economic activity is, of course, laughable. One of them must be completely out of whack with economic reality. For us, there is no question which one — the 3.9%. It has

two main statistical sources that we regard as outright phony: *first*, annualized quarterly figures; and *second*, a very low GDP deflator.

Take these two statistical gimmicks away, and you end up with the earlier mentioned mini growth rate of 0.3% in nominal terms for the second quarter. From the above citations of the Bank of Japan, we conclude that it, too, favors this measure.

But which of the two is the better measurement of economic activity? “Real” figures attempt to measure the physical volume of goods produced and sold in the economy by adjusting nominal figures with calculated inflation rates. Falling prices essentially increase real GDP growth, and rising prices decrease it. By contrast, the nominal figures simply add up the amount of money that has been spent on various demand components.

We have to say that we are principally opposed to translating falling prices into rising real GDP growth. It corresponds, of course, with the opposite practice to deduct inflation rates from nominal GDP growth. Mechanically, both seem equally logical, but economically, this equal treatment makes no sense. Consider that the steeper the fall of prices, the higher the economy’s real GDP growth rate.

For us, the decisive consideration is that the real figures tell us nothing about the movements of incomes and profits. These only show in nominal figures, based on money transactions. This may have been less important in times of high inflation, but in our time of protracted economic sluggishness, the money measure is far more important than the volume measure.

...AND AMERICAN PHANTOM GROWTH

Many times before we have expressed the same reservations about the U.S. economy’s reported performance in real GDP, showing a sharp acceleration. To us, these GDP numbers are flatly inconsistent with the disastrous employment numbers, which definitely are the far more reliable statistic. The compelling conclusion for us is that the trumpeted recovery is not a genuine recovery.

First of all, we have to point out that the “recovery,” even measured in the favorable “real” GDP numbers, compares very poorly with past postwar recoveries. The widely hailed growth rate in the second quarter was 3.3%, annualized, and forecasts for 2004 envisage 4% and perhaps a bit higher. But annual growth rates of past postwar recoveries have averaged 5.3% during the first two years after recession.

Also the view that America had its shallowest postwar recession needs drastic revision. That is true for the recession year 2001, but comparing their sluggish growth since then with the steep recoveries that followed past recessions, the U.S. economy’s performance has been singularly bad for three years.

Being aware of this fact, it strikes us that America’s bullish community strictly avoids this highly unfavorable comparison with past U.S. recoveries. Their great favorite for comparison is the economy of the eurozone, putting America’s performance into a favorable light.

We checked the numbers and found out that during the two-and-a-half years since end-2000, that is, since the creation of Europe’s common currency, America’s GDP has grown in nominal terms by a cumulative 9.9%, or 4% at annual rate. Cumulative, nominal GDP growth in the case of the eurozone since then has been 11%, or 4.2% at annual rate.

Unknown to most people, the eurozone’s GDP over this period has grown in nominal terms slightly faster than the U.S. GDP. Remember, Europe had no recession.

But the picture changes drastically when looking at reported real GDP growth since end-2001, that is, after the U.S. recession. During the one-and-a-half years until the second quarter of 2003, U.S. cumulative growth in real terms was 4.5%, as against 1.2% for the eurozone economy.

Again, a totally different picture emerges in nominal terms. The huge divergence in real terms melts to insignificance. Reported U.S. economic growth in current dollars has been 5.5% over this period, as against 5% in current euros for the eurozone.

The point to see is that only measured in real terms, the U.S. economy is grossly outperforming the Eurozone economy. Measured in nominal terms, their performance differs very little. Employment is, actually, doing far better in Europe. It has a much higher level of unemployment, but the current development is far more favorable than in the United States.

The U.S. unemployment rate is 6.1%, up from 4% in 2000 — a stunning jump of 2.1 percentage points. But these figures do not take into account the 1–2 million people who have dropped out of the labor force because they have given up looking for a job. Meanwhile, the most recent statistics from the Organisation of Economic Development show an unemployment rate of 8% for the European Union, up a scant .2% from 2000.

This raises two pertinent questions: *first*, what are the reasons for the far better U.S. performance in real terms; and *second*, what is the economic relevance of the two measures?

As to the first question, the short answer is differences in inflation statistics. Calculating real GDP, America's government statisticians use substantially lower price deflators than other countries, and for a reason that is no secret.

In their calculation of inflation rates, U.S. statisticians give great weight to quality improvements and “substitution” effects, implying that buyers shift their purchases, for example, from higher-priced steaks to lower-priced poultry. These specific adjustments are estimated to account in the case of consumer prices for at least 1 percentage point. An even stronger contribution comes from the hedonic pricing of computers, sometimes accounting for more than 40% of real GDP growth.

Paradoxically, on the one hand they complain about the harmful effects of deflation; on the other hand, they boast of the resulting higher growth rates in real terms. That leaves us with the question, which of the two measures of GDP growth — real or nominal — is more relevant as a measure of economic activity?

The short answer is, the nominal figures. In the past few years of high inflation rates, it made economic sense to adjust nominal figures downward by the inflation rates that, moreover, often sharply differed between countries. But in today's world of generally low inflation rates with income and profit deflation, it makes no economic sense anymore. The only real thing in this kind of economy is spending measured by current dollars or current euros.

In the general perception, there was a burst of spending in the United States in the second quarter. In fact, that is what the GDP figures in real terms are saying: up 1.4% in the first quarter, and up 3.3% in the third quarter.

But the reality was by no means a burst in spending but a collapsing GDP deflator, plunging abruptly to 0.8%, after 2.4% in the first quarter. The rate of nominal GDP growth, reflecting effective spending in current dollars, just inched up from 3.6% in 2002 to 4.3%, annualized, in the second quarter 2003, and that with soaring government spending. Without annualization the spending burst between the two quarters was from 0.95% to 1.1%.

HEDONIC MYSTERIES

On Sept. 5, the *Financial Times* published an article from us with the headline, “America's recovery is not what it seems.” Therein we developed the story familiar to our readers, that the U.S. economy's superior growth performance owes largely to the hedonic pricing of computers.

This provoked a critical answer from an American research institute. The writer pointed out that GDP

growth would have been very little different without hedonic pricing. Verbatim: “*The chain-weighting procedure for calculating GDP growth is designed to avoid the distortions that arise from combining hedonic pricing with fixed weights. It means that chained (1996) dollars cannot be used to measure contributions to growth.*” (We wrote an answer, by the way, that the *Financial Times* did not publish.)

But it happens that measuring contributions to GDP growth is precisely what we always want to do because we regard it as a most important question. What the writer effectively says is that the Bureau of Economic Analysis deliberately developed a method of calculating GDP growth that makes this impossible.

Fortunately, this caused some comments in the Internet from which we learned a lot more. Among other things, we learned that the BEA’s switch to chain-weighted compounding of real GDP growth had the explicit purpose to silence the attacks against hedonic pricing.

To quote the writer of this information further: “*I think, Richebächer is 100% right conceptually, but is wrong empirically. That is, his main criticism is a good point — and the Commerce Department’s Bureau of Economic Analysis agrees that it is a good point, and half a decade ago shifted the way it computes real GDP growth in order to eliminate the problem Richebächer identifies. I think Richebächer is trapped by the details of chain weighted real national accounts. Richebächer’s is a natural mistake to make: no mere human can follow all the technical changes in their national accounts that all OECD [Organisation for Economic Cooperation and Development] governments’ statistical services are doing all the time.*”

It appears, thus, that the BEA has vastly eliminated hedonic pricing through changing its pattern of calculating real GDP growth. Yet the big difference between business spending on computers, measured in chained and current dollars, remains as before.

We do not care how this difference is calculated and labeled, the decisive point is that it adds to real GDP growth by the full amount.

To specify once more the bone of contention: In tables 5.4 and 5.5 of its national data, the BEA puts the increase in business spending on computers in the first quarter of 2003 at \$0.9 billion in current dollars, and at \$15.9 billion in chained dollars. For the second quarter, the corresponding numbers are \$6.1 billion in current dollars and \$35.8 billion in chained dollars.

In the first quarter, the difference between the two measurements amounted to \$15 billion, equal to 44.3% of the recorded real GDP growth. In the second quarter, that difference amounted to \$29.7 billion, equal to 38.4% of recorded real GDP growth.

For a long time, we viewed the obsession of American policymakers and economists with computer investment as a source of economic wonders as outright grotesque. Consider, its share of GDP is a mere 0.7%, and this fraction of GDP is supposed to create 40% and more of real GDP growth. Even in the grossly inflated real terms, its share of GDP is only 3%.

JOB CREATION IS DECISIVE

What, really, are the key features of any economic recovery? Ask any person in the street, and the answer will always be the same: rising employment and rising incomes. But it happens that America’s present recovery is associated with plunging employment and sharply slower income growth, the typical signs of a recession.

The U.S. economy’s recession ended officially in November 2001. Conventionally, this marks the beginning of the recovery that has regularly followed. During these recoveries, real GDP growth averaged 5.3% with sharply rising job and income growth.

For the reasons explained, we still don’t see a genuine recovery. Even by the favorable real GDP

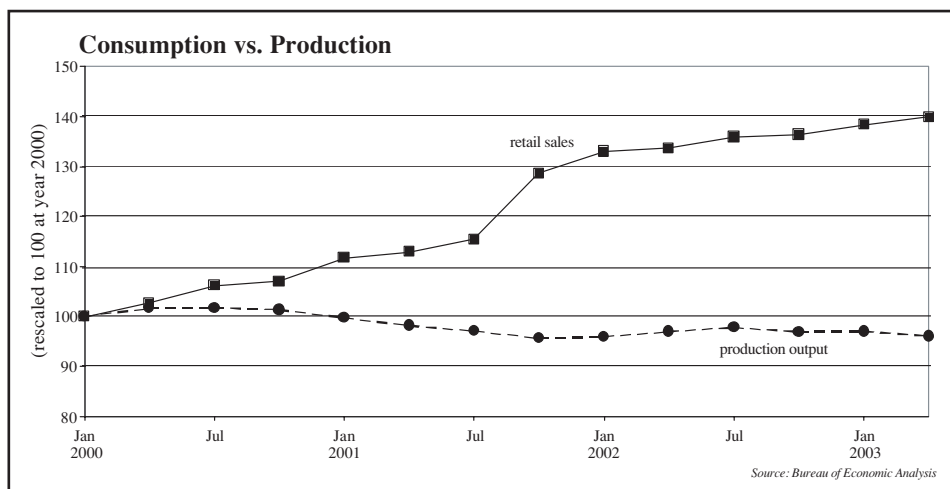
numbers, it is a far cry from past recoveries. Looking for reality, we focus on the job and income figures. At this stage, two years after the end of recessions, payroll employment in the United States had increased on average by 3.8%. This time, it is down 1%.

As already repeatedly emphasized, America's trumpeted recovery shows only in the real GDP data and in a variety of surveys and early indicators, such as the ISM, PMI and Conference Board indexes. In contrast, signs of recovery elude the nominal GDP accounts and also the hard data of economic activity, such as employment, incomes, production and new orders. All of them are below year-over-year levels and also show no meaningful acceleration.

Strong retail sales have become a main argument for the recovery — yet erroneously. We do not dispute their validity as a measure of consumer spending but their validity as a measure of economic growth. While consumer demand has remained buoyant, the soaring trade deficit has caused a disconnect between domestic demand and domestic production. The reason is that an ever-greater part of the increases in retail sales is being met via imports.

Two figures strikingly highlight the yawning gap that has opened between the two. In August, retail sales volume was up 6.3% year-over-year; manufacturing production was down 1.4%. The difference feeds the soaring trade deficit.

And this horrendous gap between domestic spending and domestic output is one obvious main reason for the poor job performance. Since end-2001, domestic spending on durable and nondurable goods grew by \$226.6 billion. Net goods imports, on the other hand, grew by \$156 billion. Imagine, domestic producers snatched barely a third of the increase in spending on manufactured goods.



It is apparently not widely realized that America's employment performance in the last few years has been the worst among major countries, worse even than in Europe. In September, U.S. payroll employment was about 2.7 million below its peak reached in February 2001.

The reported U.S. job losses are most probably understated. The payroll survey from which the figures come covers a sample of 400,000 existing establishments. But the Bureau of Labor Statistics assumes that an economic upswing regularly gives birth to many new small firms creating jobs in addition to existing firms. Trying to account for them, the BLS regularly puts an estimated number to its effective survey results, colloquially called "phantom" jobs. So far this year, this has added almost 600,000 workers to reported payrolls. Last year, more than 500,000 were later revised away.

Closing these reflections about America's strange "job-loss" recovery, we have to ask once more: Is this a genuine recovery? Definitely not. For a genuine recovery, substantial job creation is an essential element.

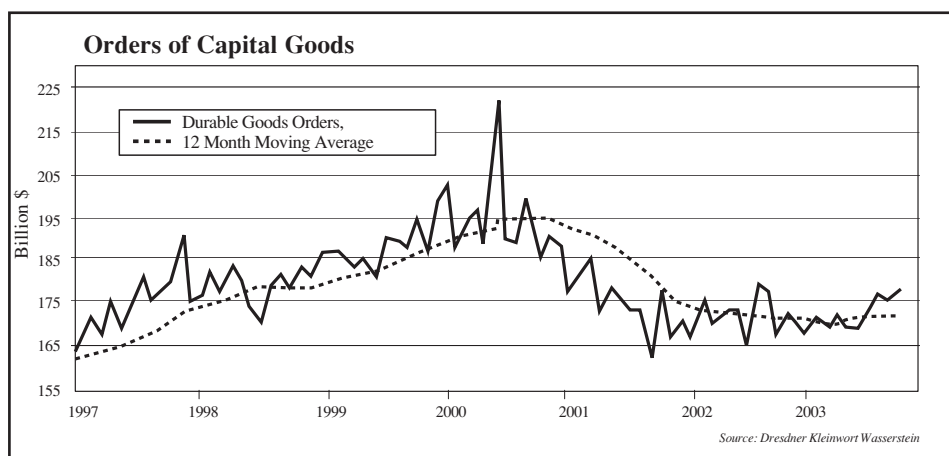
THE BALANCE SHEET BRAKE

What's more, strong job and associated income growth provide the essential fuel for the indispensable strong growth in consumer spending. This time, the pattern is radically different. It is the bond bubble and

the accompanying housing and mortgage refinancing bubble that fuel consumer spending, instead. The question now is whether or not business investment spending will take over as the locomotive for employment and income growth, or whether weakness in consumer spending will join weakness in investment spending.

The conventional reports say that high-tech investment is sharply recovering. It is another big distortion and illusion about the U.S. economy. Year-over-year, nonresidential business investment in the second quarter was up in current dollars from \$1,115.8 billion to \$1,119 billion and in real terms from \$1,181.1 billion to \$1,193 billion.

Within the total in real terms, one single component stands out with an explosive rise. Guess what it is? Business investment in computers at hedonic prices. In current dollars, it rose \$9.6 billion, accounting for 2.2% of nominal GDP growth during the 12 months to the second quarter of 2003. In chained dollars, it soared by \$83.3 billion, accounting for 35% of real GDP growth.



Is business capital investment recovering or not? In our view the only thing economically relevant are the dollars actually paid and received, and that is the \$9.6 billion in current dollars. This minimal sum belies any recovery. Strikingly, capital goods orders and shipments, a good proxy for investment spending, have been stuck in a sideways range, having shown no worthwhile improvement for two years. September, though, brought an uptick.

It may be, however, that favorable conditions for an investment recovery are falling in place. There are two key conditions: *first*, solid and liquid balance sheets; and *second*, good corporate profit prospects.

But U.S. corporations emerged from the late-'90s boom with drastically weakened balance sheets and plummeting profits. Corporate debt soared as a ratio of GDP, while corporate profits slumped to unprecedented lows. What has been happening to remedy these two crucial maladjustments? Our short answer is: nothing serious.

Corporations have responded with aggressive cost-cutting. For the consensus, this is the best and most reliable way to improve both balance sheets and profits. It is a grossly fallacious assumption. From the macro perspective, it makes everything worse because it essentially exerts further downward pressure on the economy.

Corporate liquidity is not improving at all. Business net investment — gross investment in excess of depreciations — has been flat since 2001. Under this condition, it would be normal for businesses in the aggregate to run a financial surplus. But debts, up since then by \$385.5 billion, continue to rise much faster than the holdings of financial assets, up \$282.4 billion.

And its main cause is easy to see. The continuous net new corporate borrowing largely serves to pay unearned dividends. For the first time in the whole postwar period, corporations are paying dividends in excess of their earnings. Traditionally, American corporations have funded their expansion through investment spending with a high rate of retained earnings.

Between 1950–1979, the business savings rate net of depreciation was 2.9% of GDP. In relation to today's GDP that would come to about \$300 billion of retained earnings. In 2002, nonfinancial corporations paid record-high dividends of \$285 billion, of which \$88.8 billion, or about one-third, were funded with borrowed money. In other words, business saving is gone; it is heavily negative.

What is going on here? It is the familiar old game. Supporting share prices has absolute priority. On second thought, it is obviously another way of misleading investors about profitability.

But most importantly: The alleged strengthening of corporate balance sheets is another chimera about the U.S. economy. These continue to weaken. Nevertheless, there is an alternative. The normal and also easiest way to strengthen corporate balance sheets is to issue stocks. But most remarkably, that is not happening either, even though at 32 times earnings for the S&P 500, it would be extremely cheap capital.

SHORT OF OPTIMISM OR SHORT OF MONEY?

Since their lows in mid-March, stock markets around the world have rallied impressively. But even though the U.S. economy is generally perceived to be performing even better than expected, U.S. and world stock markets have recently opted out and stalled. Since early September, they are just trickling sideways.

We wonder about the reason. Is it waning optimism about the economy and profits, or is it lack of money on the part of investors? The fact is that volume, the weapon of the bull, has been less than aggressive on the rally days.

To have a sustained bull run in stock prices, it crucially needs two things: *first*, high-riding profit expectations; and *second*, a lot of money and credit on the part of willing investors.

In the late 1990s, both existed in overabundance. Sharply higher productivity growth was the sustenance of expected earnings vigor. The profit expectations proved badly flawed. America's expected profit miracle turned into America's worst postwar profit carnage.

But the developing stock market bubble had yet another reason: exorbitant buying by two extraordinary buyers — corporations and foreigners. In reality, the two were the true key drivers of the stock market's protracted bull run. In their absence, the market would have developed very differently. Private households gained enormously from soaring stock prices. Yet essentially they were net sellers.

Realizing that the buying binge of American stocks during the late 1990s on the part of corporations and foreigners is definitely over, we have been wondering for some time from where the strong buying of stocks for a new, protracted bull run may possibly come. Leaving aside speculators, there is but one possible main source: private households. Putting it precisely: It is their savings from current income. Looking at the trickle of such savings in the United States, it is hard to imagine that they can possibly create a stock market boom.

In a bubble economy that has got rid of its domestic savings, like the United States, the financial markets essentially depend on infinite money and credit creation. But keeping interest rates artificially low and the asset bubble levitated, the scope of new liquidity injections is expanding exponentially.

However, between mid-2002 and mid-2003, U.S. private households pocketed income and liquidity injections of unprecedented size from tax cuts and the mortgage refinancing bubble, altogether well over \$600 billion. As optimistic forecasts for the economy abounded, some of that money found its way into the stock market, as the first new inflows into mutual funds show.

Still, it has always been clear to us that the savings-shy American consumer does not have the

wherewithal to stage a protracted stock market boom. The untold story behind the spring and summer stock rally in high-tech shares has been the return to heavy buying on margin debt extended by brokerage firms.

By the summer of 2001, Nasdaq margin debt had plunged to \$5.07 billion from around \$21 billion in March 2000. By last July, it had ballooned to \$26 billion, exceeding its peak at the height of the stock market bubble in early 2000. Obviously, the bubble is back, powering impressive gains in technology, biotechnology and Internet stocks. The biotech stock index is up over 55% since March lows. The Internet index is up 120% in that same time.

A stark piece of new insanity comes from Amazon, the giant bookseller and auctioneer. Its share price has seen a 200% rise in this calendar year, although its shareholder equity has fallen from zero in March 2000 to negative \$1.25 billion in July 2003.

CONCLUSIONS

In the consensus view, the U.S. economy in the second quarter has gathered speed tremendously. Sustained, accelerating growth is taken for granted. We continue to observe something very different. The signs and signals of a strong recovery are confined to surveys, early indicators and GDP accounts in “chained” dollars, heavily bolstered by low deflators. Looking at employment, incomes and GDP account in current dollars, the U.S. economy remains close to recession or stagnation.

Boosted by big tax cuts, the third quarter will probably show a true spurt in spending. But do not let yourself be fooled by annualized GDP numbers and creative accounting through bogus deflators. In the second quarter, growth in consumer spending slightly declined quarter-over-quarter in current dollars from \$87.1 billion to \$86.1 billion, but in chained dollars it soared mysteriously from \$33 billion to \$63 billion, accounting for 39% of real GDP growth.

Profit improvements are grabbing headlines. From our macro analysis, we conclude that a meaningful improvement in profits from production and sales of products is out of the question. But there were currency gains, tax cuts and big profits from the carry trade of bonds. Record-high stock selling by insiders appears to us in this respect a compelling confirmation and a warning sign.

A self-sustaining recovery requires a joint surge in consumer and business spending. We expect that after the third quarter, sharply slowing consumer spending will join persistently weak investment spending.

There are two big threats to consumer spending. One is the complete absence of pent-up demand, and the other is the deflating mortgage refinancing bubble.

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